ASK THE EXPERT

A new tax landscape for manufacturers and distributors

The Tax Cuts and Jobs Act of 2017 reduced tax rates and changed many of the existing rules. Therefore, every business should take a second look at its tax strategy, as it may no longer be effective under the new rules. The new provisions have a significant impact on the manufacturing and distribution industry.

Crain's Custom interviewed accounting and advisory firm Citrin Cooperman to find out how the new tax code will affect U.S.-based companies with overseas operations. We spoke with certified public accountants Rita Chung, transfer pricing partner; Paul Dailey, tax partner; and John Giordano, manufacturing and distribution co-practice leader.

Q *Crain's:* What are some of the main provisions of the Tax Cuts and Job Act that manufacturers and distributors should consider?

A *Dailey*: For C corporations only, the new foreign-derived intangible income deduction can reduce the federal corporate tax rate to 13.125%. This attractive rate was intended to compete with the patent box regimes of some European countries, as it provides for lower rates relating to intangible property. However, the term "intangible" is a misnomer; FDII applies to all income derived from property or services that is destined for foreign use and that exceeds a deemed tangible property return.

The C corporate taxpayer is allowed a deduction of 37.5% of FDII, resulting in an overall tax rate of 13.125%. In general, FDII is the foreign-source portion of a U.S. C-corporation's gross income that exceeds 10% of the adjusted tax basis of its depreciable assets. Certain types of income are excluded—notably subpart F income, financial services income and global intangible low-taxed income.

Giordano: In addition, under the Section 199A deduction for pass-through entities, eligible taxpayers can deduct up to 20% of qualified business income from a domestic sole proprietorship, partnership or S corporation, subject to specific limitations. This could effectively drop the maximum federal rate to 29.6% for some taxpayers.

Q *Crain's:* Will FDII change the way M&D companies based in the U.S. structure their offshore arrangements?

A *Dailey*: The IC-DISC, a tax-advantaged entity for qualifying U.S. exporters, could become less popular. For instance, the spread between qualified dividend rates and the maximum rate on ordinary income used to be 15.8%. That will be reduced to 5.8% if the new Section 199A deduction is allowed in full. In addition, the IC-DISC regime only provides for a deferral of the tax liability attributable to $10 million of export receipts. The full corporate rate of 21% must be paid eventually. Contrast that with the 13.125% corporate-tax rate under FDII, with no cap on foreign gross receipts.

Chung: Traditionally, a significant number of M&D companies preferred holding valuable intellectual property such as manufacturing know-how, process, design or technical data etc., offshore in a low-taxing jurisdiction. FDII may prompt U.S. multinationals to reconsider that ownership structure.

There could still be drawbacks to migrating the IP back to the U.S., however. For instance, many countries impose an "exit tax" on companies migrating valuable IP. Another consideration is the longevity of FDII. Once the IP is moved back to the U.S. the U.S. company will have to pay another exit tax, pursuant to Section 367, if it decides to migrate the IP again.

Q *Crain's:* Prior to the TCJA, transfer pricing played a significant role in the way U.S.-based companies transacted with foreign affiliates. How do you think transfer pricing will be impacted?

A *Chung*: In general, given the new, lower tax rate in the U.S. there are fewer incentives for U.S. multinationals to leave income offshore, and U.S. companies may become complacent about their transfer pricing. However, the transfer pricing environment is changing around the world in light of base erosion and profit shifting, or BEPS—the corporate tax planning strategies used by multinationals to "shift" profits from high-taxing jurisdictions to low-taxing jurisdictions. Although the U.S. remains one of the most aggressive enforcers of transfer pricing, many countries around the world have adopted rules for its enforcement. U.S. multinationals should structure their inter-company transactions to be compliant with TP regulations in all taxing jurisdictions to avoid double taxation.

Q Crain's: What are some other new provisions that will affect taxable income for M&D companies?

A *Dailey*: Section 163(j) enacts an interest-stripping provision, disallowing all interest expense in excess of 30% of adjusted taxable income. Any excess will carry forward indefinitely for C-corporate taxpayers. For pass-through owners, the disallowed interest of the entity is treated as excess business interest like any other non-separately stated item of taxable income or loss. Adjusted taxable income is based upon earnings before depreciation and amortization for years beginning before Jan.1, 2022. Afterwards, it's calculated after depreciation and amortization.

There are two significant exceptions to the new interest-limitation provisions: They do not apply to real estate activities or to any taxpayer whose average gross receipts for the three preceding years do not exceed $25 million.

Giordano: To incentivize owners to purchase the necessary equipment to build out U.S.-manufacturing facilities, the TCJA extended and modified bonus depreciation, allowing businesses to immediately deduct 100% of the cost of certain eligible property in the year it is placed in service, through 2022. The TCJA also made bonus depreciation apply in more circumstances. However, there is an unintended glitch in the new law. Qualified leasehold improvements are apparently not subject to bonus depreciation, absent a changed technical corrections bill.

Q *Crain's:* What are some of the important tax incentives that have not been eliminated by the TCJA?

A *Dailey*: The research-and-development credit is still alive and kicking. The R&D credit benefits M&D companies performing qualified research activities in the U.S. The credit is equal to 20% of the excess of qualified research expenses over a base period amount. A qualified small business may elect to apply up to $250,000 of R&D credits against payroll taxes, which could prove extremely beneficial to startup companies. ■

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